



# **Legislative Audit Division**

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**State of Montana**

**Report to the Legislature**

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**October 2005**

## **Financial Audit**

**For the Fiscal Year Ended June 30, 2005**

## **Montana State Fund**

**A Component Unit of the State of Montana**

**This is our financial audit report on the Montana State Fund for the fiscal year ending June 30, 2005. The objectives of our financial audit include determining if the Montana State Fund's financial statements present fairly its financial position and results of operations at and for the period ending June 30, 2005, with comparative totals at and for the period ending June 30, 2004.**

**This report contains no recommendations.**

**Direct comments/inquiries to:  
Legislative Audit Division  
Room 160, State Capitol  
PO Box 201705  
Helena MT 59620-1705**

**05-05**

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## FINANCIAL AUDITS

Financial audits are conducted by the Legislative Audit Division to determine if the financial statements included in this report are presented fairly and the agency has complied with laws and regulations having a direct and material effect on the financial statements. In performing the audit work, the audit staff uses standards set forth by the American Institute of Certified Public Accountants and the United States Government Accountability Office. Financial audit staff members hold degrees with an emphasis in accounting. Most staff members hold Certified Public Accountant (CPA) certificates.

Government Auditing Standards, the Single Audit Act Amendments of 1996 and OMB Circular A-133 require the auditor to issue certain financial, internal control, and compliance reports. This individual agency audit report is not intended to comply with these requirements and is therefore not intended for distribution to federal grantor agencies. The Legislative Audit Division issues a statewide biennial Single Audit Report which complies with the above reporting requirements. The Single Audit Report for the two fiscal years ended June 30, 2005, will be issued by March 31, 2006. The Single Audit Report for the two fiscal years ended June 30, 2003, was issued on March 23, 2004. Copies of the Single Audit Report can be obtained by contacting:

Single Audit Coordinator  
Office of Budget and Program Planning  
State Capitol  
Helena MT 59620  
Phone (406) 444-3616

Legislative Audit Division  
Room 160, State Capitol  
PO Box 201705  
Helena MT 59620-1705

### MEMBERS OF THE LEGISLATIVE AUDIT COMMITTEE

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Senator John Brueggeman  
Senator Jim Elliott  
Senator Dan Harrington  
Senator Lynda Moss  
Senator Corey Stapleton

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Representative Hal Jacobson  
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Representative Scott Mendenhall  
Representative John Musgrove  
Representative Janna Taylor

# LEGISLATIVE AUDIT DIVISION

Scott A. Seacat, Legislative Auditor  
John W. Northey, Legal Counsel



Deputy Legislative Auditors:  
Jim Pellegrini, Performance Audit  
Tori Hunthausen, IS Audit & Operations  
James Gillett, Financial-Compliance Audit

October 2005

The Legislative Audit Committee  
of the Montana State Legislature:

This is our report on the Financial audit of the Montana State Fund, a component unit of the State of Montana, for the fiscal year ended June 30, 2005. The objectives of this audit include determining if the financial statements for fiscal year 2004-05, with comparative financial amounts for fiscal year 2003-04, present fairly the Montana State Fund's financial position at June 30 for each fiscal year and the results of its operations for the fiscal years then ended. We also tested compliance with laws that have a direct and material effect on the financial statements.

We made no recommendations to Montana State Fund in the current or prior audit report. On page A-1, you will find the Independent Auditor's Report followed by the Management's Discussion and Analysis, the financial statements and accompanying notes. The Management's Discussion and Analysis is supplementary information required by the Governmental Accounting Standards Board. As disclosed in the Independent Auditor's Report, we did not audit the information and express no opinion on it. We issued an unqualified opinion on the financial statements, which means the reader can rely on the information presented.

Montana State Fund is a workers' compensation insurance company established by the state of Montana. It is a nonprofit, quasi-public entity that provides Montana employers with an option for workers' compensation and occupational disease insurance. Montana State Fund is governed by a seven-member board of directors appointed by the governor. State law separates funding sources for claims incurred before July 1, 1990 (Old Fund) and those incurred on or after July 1, 1990 (New Fund).

Montana State Fund management must set premium rates at amounts sufficient, when invested, to carry the estimated cost of all claims to maturity, to meet the reasonable expenses of conducting the business of the New Fund, and to maintain an excess of surplus over the amount produced by the National Association of Insurance Commissioners' risk-based capital requirements for a casualty insurer. The Old Fund costs are currently funded by investment earnings. The investments of the Montana State Fund are managed by the Montana Board of Investments and invested according to policies established in law.

Montana State Fund's response to our audit is on page B-1. We thank the Montana State Fund staff for their cooperation and assistance during the audit.

Respectfully submitted,

*/s/ Scott A Seacat*

Scott A. Seacat  
Legislative Auditor

## **Appointed and Administrative Officials**

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### **Montana State Fund**

Laurence Hubbard	President/CEO
Mark Barry	Vice President, Corporate Support
Tony Johnson	Vice President, Human Resources
Layne Kertamus	Vice President, Insurance Operations
Peter Strauss	Vice President, Insurance Operations Support
Nancy Butler	General Counsel
Al Parisian	Chief Information Officer

### **State Fund Board of Directors**

	<u>Term Expires</u>
Ed Henrich	2007
Mardi Madsen	2007
Jane DeBruycker	2009
Ken Johnson	2009
Jim Swanson	2009
Lance Zanto	2009

For additional information concerning the Montana State Fund, contact:

Laurence Hubbard, President/CEO  
5 South Last Chance Gulch  
Helena MT 59601  
(406) 444-6501

Members of the audit staff involved in this audit were Laurie Barrett, Chris G. Darragh, John Fine, Geri Hoffman, Jim Manning, Delsi Plummer, and Vickie Rauser.

# LEGISLATIVE AUDIT DIVISION

Scott A. Seacat, Legislative Auditor  
John W. Northey, Legal Counsel



Deputy Legislative Auditors:  
Jim Pellegrini, Performance Audit  
Tori Hunthausen, IS Audit & Operations  
James Gillett, Financial-Compliance Audit

## INDEPENDENT AUDITOR'S REPORT

The Legislative Audit Committee  
of the Montana State Legislature:

We have audited the accompanying Statements of Net Assets, New Fund and Old Fund, of the Montana State Fund, a component unit of the state of Montana, as of June 30, 2005 and 2004, and the related Statements of Revenues, Expenses, and Changes in Fund Net Assets, New Fund and Old Fund, and the Statements of Cash Flows, New Fund and Old Fund, for the fiscal years then ended. The information contained in these financial statements is the responsibility of the Montana State Fund's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Montana State Fund as of June 30, 2005 and 2004, and the results of its operations and its cash flows for the fiscal years then ended in conformity with accounting principles generally accepted in the United States of America.

The accompanying Management's Discussion and Analysis is not a required part of the financial statements but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Respectfully submitted,

*/s/ James Gillett*

James Gillett, CPA  
Deputy Legislative Auditor

October 5, 2005



**Montana State Fund's  
Management Discussion and Analysis,  
Financial Statements and Notes**

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**Montana State Fund**  
(A Component Unit of the State of Montana)  
Management Discussion and Analysis  
June 30, 2005 and 2004

**Description of Business**

The Montana State Fund (MSF) is a nonprofit, quasi-public entity established under Title 39, Chapter 71 of the Montana Code Annotated (MCA). MSF provides Montana employers with an option for workers' compensation and occupational disease insurance and guarantees available coverage for all employers in Montana. MSF is governed by a seven member Board of Directors appointed by the Governor. MSF is attached to the State of Montana, Department of Administration for administrative purposes only.

During the 1990 Montana Special Legislative Session, legislation passed establishing separate funding and accounts for claims of injuries resulting from accidents occurring before July 1, 1990, referred to as the Old Fund, and claims occurring on or after July 1, 1990, referred to as MSF. Hereafter, any reference to MSF refers to the New Fund or those claims occurring after July 1, 1990.

MSF functions as an autonomous insurance entity supported solely from its own revenues. All assets, debts, and obligations of MSF are separate and distinct from assets, debts, and obligations of the State of Montana. No State general fund money is used for MSF operations. If MSF is dissolved by an act of law, the money held by MSF is subject to the disposition provided by the legislature enacting the dissolution with due regard given to obligations incurred and existing (Section 39-71-2322, MCA). MSF administers and manages the claims remaining in the Old Fund for the State of Montana and is the administering entity for recording the financial activity related to receipt and disbursement of funds held in the Old Fund.

MSF financial statements are presented as a component unit in the State of Montana Comprehensive Annual Financial Report. MSF uses the accrual basis of accounting, as defined by generally accepted accounting principles, for its workers' compensation insurance operations. Under the accrual basis, MSF records revenues in the accounting period earned, if measurable, and records expenses in the period incurred, if measurable.

**Financial Position – MSF**

MSF's financial position strengthened from fiscal year 2004 to 2005. Total net assets increased from \$142.8M (million) in 2004 to \$168.7M in 2005, an increase of 18.1%. Estimated claims payable increased \$59.5M from 2004 to 2005, an increase of 13.1%. The estimated claims payable increase included reserve strengthening of \$15.2M on prior year losses. Benefit payments increased 14.6% from 2004 to 2005 while operating expenses for 2005 increased 3.1% over operating expenses in 2004. Premium grew by 35.9% from 2004 to 2005. Total net earned



premium in 2005 is \$189.4M, up from \$139.4M in 2004. The following discussion will explain the reasons for these changes and provide additional background to MSF's financial position.

### Assets

At June 30, 2005, total invested assets (cash and cash equivalents, long term fixed securities, and equities) are \$688.2M. This is an increase of \$85.4M or 14.2% of the invested assets held at June 30, 2004. In 2005, the book value of equity securities remained at \$68.4M from 2004. In 2005, the equity securities' carrying value, which includes an \$8.3M unrealized gain, is \$76.7M, or 11.2% of MSF's total cash and investments. In 2004, the equity securities' carrying value, which includes a \$3.7M unrealized gain, was \$72.1M which was 12.0% of MSF's total cash and investments. Total bonds in 2005 have increased to \$579.3M up from \$509.9M in 2004. This results in a bond to total cash and investment ratio of 84.2% in 2005 compared to 84.6% in 2004. Cash and cash equivalents are classified as current assets and increased from \$20.7M in 2004 to \$32.2M in 2005. The increase of \$11.5M is mainly attributable to an increase in MSF's portion of the short-term investment pool (STIP). In 2005, our STIP balance is \$29.5M compared to \$18.2M in 2004.

Under the provisions of the state constitution, MSF's invested assets are managed by the Montana Board of Investments (BOI). The BOI has, by a Securities Lending Authorization Agreement, authorized the custodial bank to lend MSF's securities to broker-dealers and other entities with a simultaneous agreement to return the collateral for the same securities in the future. State Street Bank was appointed the BOI's custodial bank on December 1, 1993. During the period the securities are on loan, BOI receives a fee and the bank must initially receive collateral equal to 102% of the market value of the securities on loan and must maintain collateral equal to but not less than 100% of the market value of the loaned security. BOI retains all rights of ownership during the loan period. The total cash collateral held at the end of fiscal year 2005 is \$101.9M compared to \$141.0M in 2004, all of which is classified as a short-term asset with an offsetting short-term liability.

Net premiums receivable, at \$4.6M in 2005, decreased from prior year's net premiums receivable of \$5.2M. Net receivables are expected to be collectible within one year. Other receivables for fiscal year 2005 consist of interest receivables of \$8.2M and notes receivable of \$146K (thousand) of which \$36K is long term. Other receivables for fiscal year 2004 consist of interest receivables of \$7.5M and notes receivable of \$142K, of which \$37K is long term.

Equipment decreased \$147K from fiscal year 2004 with fiscal year 2005 acquisitions of \$337K offset by retirements of \$484K. Acquisitions and retirements consisted primarily of information technology equipment. This compares to fiscal year 2004 acquisitions of \$523K offset by retirements of \$357K. Accumulated depreciation increased \$50K from year to year due to fiscal year 2005 depreciation expense of \$455K and allocated depreciation expense of \$32K to Old Fund offset by the related accumulated depreciation associated with retirements of \$437K. Depreciation expense in fiscal year 2004 totaled \$521K with the Old Fund allocation of \$87K offset by the related accumulated depreciation associated with retirements of \$525K.

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In fiscal year 2005, intangible assets increased to \$3.7M from \$1.1M in 2004. Fiscal year 2005 acquisitions are \$3.1M offset by amortization expense of \$407K and allocated amortization expense of \$166K to Old Fund. Included as intangible acquisitions are \$2.7M spent on Montana State Fund's new Claim Center which will not be put into production until FY 2006. Fiscal year 2004 acquisitions were \$503K offset by amortization expense of \$1.1M and allocated amortization of \$90K to Old Fund.

Other assets increased to \$8.4M in 2005 from \$2.0M in 2004. Other assets are comprised of prepaid expenses, other advances, property held in trust and deferred acquisition costs. The increase of \$6.4M is due primarily to the recording of an asset, property held in trust, of the funds withheld amount required by MSF's Aggregate Stop Loss Treaty. The funds withheld will be repaid to Montana State Fund upon commutation of the Aggregate Stop Loss Treaty.

### Liabilities

Tillinghast-Towers Perrin, an independent actuarial firm, prepares an actuarial study used to estimate liabilities and the ultimate cost of settling claims reported but not settled and claims incurred but not reported (IBNR) for MSF as of June 30, 2005 and June 30, 2004. Tillinghast-Towers Perrin provides a range of potential costs associated with reported claims, the future development of those claims and IBNR. MSF management has selected the best estimate within that range as the estimated claims payable, consisting of unpaid claims and claim adjustment expenses, for fiscal years 2005 and 2004. The estimated claims payable is presented undiscounted, net of estimated reinsurance recoverable, at \$511.6M and \$452.1M, as of June 30, 2005 and June 30, 2004, respectively.

The estimated claims payable increased \$59.5M from 2004 to 2005 primarily due to reserve strengthening of \$15.2M on prior year claims. The estimated claims payable also includes \$4.6M for contingencies due to recent court decisions. MSF currently has no knowledge of any significant environmental or asbestos claims that would contribute to this estimate. The current portion of the estimated claims payable, or the portion of the payable expected to be paid within the next twelve months are \$110.9M and \$99.7M for fiscal years 2005 and 2004 respectively. The balance of the estimated claims payable, classified as long-term, are \$400.7M for fiscal year 2005 and \$352.4M for fiscal year 2004.

Property held in trust increased to \$13.1M in 2005, up from \$8.5M in 2004 due to the funds withheld account requirement of MSF's aggregate stop loss reinsurance treaty. The three-year treaty, effective July 1, 2002, includes a provision for MSF to maintain a funds withheld account which totaled \$8.8M for fiscal year 2005. In fiscal year 2004 the funds withheld account totaled \$5.2M. The funds withheld account is accruing interest at 6.5% for both fiscal years 2005 and 2004.

Deferred revenue decreased to \$4.9M in 2005 from \$6.0M in 2004 due to a larger percentage of the policy billings being earned during the fiscal period. The entire balance is classified as short-term since the billings are for one year or less.

As discussed above in the *Assets* section, the BOI has a Securities Lending Authorization Agreement to lend MSF's securities to broker-dealers and other entities with a simultaneous agreement to return the collateral for the same securities in the future. The total collateral owed at the end of fiscal year 2005 is \$101.9M compared to \$141.1M in 2004, all of which is classified as a short-term liability with an offsetting short-term asset.

Other MSF payables consist of accounts payable and compensated absences. Accounts payable experienced the greatest change from prior year and increased to \$13.7M at June 30, 2005, up from \$8.2M at June 30, 2004. The majority of this increase is attributable to an investment purchased in 2005 by the Board Of Investments that was not settled until fiscal year 2006.

### Net Assets

During fiscal year 2005, net assets increased from \$142.8M in 2004 to \$168.7M in 2005 due to a net income of \$25.9M. Net assets are reported as net of related debt.

## **Results of Operations – MSF**

### Net Premiums Earned

Net premiums earned in fiscal year 2005 totaled \$189.4M, up from \$139.4M in 2004, a 35.9% increase. The increase is driven by a significant number of new policies and increased pricing on renewing policies. MSF writes other states coverage for Montana state-domiciled insured's that have locations in states other than Montana. Other states coverage assumed premium for fiscal years 2005 and 2004 is \$2.7M and \$2.0M respectively.

### Investment Income

Investment income for fiscal year 2005 was \$35.9M as compared to \$15.0M for fiscal year 2004. The \$20.9M increase in investment income is wholly attributable to the change in unrealized gains and losses on invested assets. In fiscal year 2005, unrealized gains on invested assets are \$6.8M including unrealized gains on equities of \$4.6M and unrealized gains on fixed income securities of \$2.2M. In fiscal year 2004, MSF had unrealized losses on invested assets of (\$11.6M), that included unrealized losses on fixed security investments of (\$24.4M) and unrealized gains on equity holdings of \$12.8M. Net investment earnings on all other investment activity including interest earnings, realized gains or losses on sales of investments and net securities lending activity for fiscal year 2005 was \$30.2M as compared to \$27.8M in fiscal year 2004. This \$2.4M increase can be attributed to the increased investment in fixed income securities in fiscal year 2005 of \$579.3M compared to \$509.9M in 2004.

Net realized gains decreased to \$1.1M in 2005, down from \$1.8M in 2004 primarily due to decreased sales of bonds during fiscal year 2005. In 2005, bond sales were \$91.9M compared to \$97.2M in 2004. Net realized losses decreased to \$77K in 2005, down from \$742K in 2004. Securities lending income increased to \$2.4M in 2005 from \$939K in 2004. The associated expense also increased to \$2.3M in 2005 from \$846K in 2004.



### Operating Expenses

Claim benefits to injured employees in 2005 are \$159.6M on an incurred basis compared to \$139.2M in 2004, an increase of \$20.4M. The increase is driven primarily by the change in the estimated claims liability. In 2005, the estimated claims liability increased by \$59.5M compared to \$38.7M in 2004 and is discussed in more detail in the *Liabilities* section above. Medical and indemnity costs remained constant in 2005 with the amounts incurred in 2004. Medical payments decreased 2.9% while indemnity payments increased 2.6%.

Personal services increased from \$15.4M in 2004 to \$17.2M in 2005, an 11.6% increase. Commission expense decreased by \$133K in 2005 due to commissions earned under MSF's Aggregate Stop Loss Reinsurance Treaty. Contracted services increased \$72K in fiscal year 2005 due primarily to higher consulting and professional services and audit fees. Supplies and materials increased by \$122K in fiscal year 2005 due to greater purchases of minor equipment and software.

Depreciation expense for fiscal year 2005 decreased \$65K from fiscal year 2004 and amortization expense for fiscal year 2005 decreased \$737K from fiscal year 2004.

Other operating expenses decreased by \$559K in 2005. The decrease is due to reductions in bad debt expense and deferred acquisition cost amortization for 2005. Other operating expenses for 2005 also include funds withheld interest of \$547K.

### Other Non-operating Revenue and Expenses

Other transactions impacting net assets include dividends paid to policyholders, which totaled \$5.0M in 2005 and \$1.9M in 2004. Dividends are paid based upon the recommendation of management and the subsequent approval of the Board of Directors. Dividend amounts are determined based on analytical results of the current state of MSF. MSF's results as of 12/31/04 had improved in comparison to 12/31/03 which resulted in the recommendation and approval of a higher dividend paid in this fiscal year.

### Change in Net Assets

Results of operations for fiscal year 2005 showed a decrease in operating loss of \$28.5M resulting from an operating loss of (\$6.2M) compared to an operating loss for fiscal year 2004 of (\$34.7M). At the same time non-operating revenue for fiscal year 2005 was \$32.1M compared to non-operating revenue of \$14.4M for fiscal year 2004 resulting in an increase of non-operating revenue of \$17.7M. The change in net assets for fiscal 2005, results of operations plus non-operating revenue, is an increase of \$25.9M. The change in net assets for fiscal year 2004 is a decrease of (\$20.3M). The fiscal year 2005 change in net assets increased from fiscal year 2004 by \$46.2M.

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## **Financial Position – Old Fund**

The Old Fund's deficit position weakened by (\$8.2M) in fiscal year 2005 compared to fiscal year 2004 and is now at \$(15.6M). The Old Fund's deficit grew in large part to the increase in the ultimate loss selection of \$5.6M over fiscal year 2004 determined by the consulting actuary. In addition to this, the discount rate applied to the remaining Old Fund reserves was decreased to 5.0% from 5.25% resulting in \$949K of additional reserves. Additional reserves of \$800K were also added for known court contingencies.

### **Assets**

Old Fund's investment portfolio consists of long-term bonds, which decreased to \$51.4M in fiscal year 2005 from \$69.2M in fiscal year 2004. The bond to total cash and investment ratio for 2005 is 80.8% compared to 94.4% for 2004. As reserve levels decrease and funds are transferred out of Old Fund, monies to be invested decrease. For further explanation, see the estimated claims payable and transfer discussions below in the *Liabilities* and *Other Nonoperating Revenue and Expenses* sections.

Interest receivable for the year ended June 30, 2005 is \$653K compared to \$1.0M for year ended June 30, 2004. Net accounts receivable consists of medical overpayments and remaining receivables from the Old Fund Liability Tax. Net accounts receivable due from external sources for 2005 is \$51K, down from \$64K in 2004.

Old Fund is also a part of the BOI's Securities Lending Authorization Agreement and therefore has securities lending collateral. The total cash collateral owed at the end of fiscal year 2005 is \$17.8M compared to \$13.2M in 2004, all of which is classified as a short-term liability with an offsetting short-term asset.

### **Liabilities**

An actuarial study prepared by Tillinghast-Towers Perrin for the Old Fund as of June 30, 2005 and June 30, 2004, is used to estimate liabilities and the ultimate cost of settling claims that have been reported, but not settled, and claims that have been incurred, but not reported (IBNR). Tillinghast-Towers Perrin provides a range of potential costs associated with reported claims, the future development of those claims and IBNR. Tillinghast also provides an estimate of these liabilities at present value to reflect investment earnings of the assets invested to pay claims. MSF management has selected the best estimate within that range as the estimated claims payable, consisting of unpaid claims and claim adjustment expenses, for fiscal years 2005 and 2004. As of June 30, 2005, the undiscounted estimated claims payable is \$104.9M and is presented at net present value of \$79.1M discounted at 5.0%. As of June 30, 2004, the undiscounted estimated claims payable is \$108.5M and is presented at net present value of \$80.8M discounted at 5.25%. Claim benefit payments decreased to \$8.7M in 2005 compared to \$11.6M in 2004.

Reserve levels will continue to decrease with time, since Old Fund has no new claims but continues to pay on already-existing claims. As reserve levels decrease, so will the need to fund those levels resulting in decreasing investment needs over time. This trend is evident with the lower 2005 estimated claims payable and investment balances when compared to 2004. The short-term portions of the estimated claims payable are \$10.3M and \$14.4M for fiscal years 2005 and 2004, respectively. The long-term portions of the payable are \$68.8M and \$66.4M for fiscal years 2005 and 2004, respectively.

### Net Assets

During fiscal year 2005, total net assets decreased from \$(7.4M) in 2004 to \$(15.6M) in 2005 due to a net loss of (\$8.2M). The negative net asset balance is the direct result of the transfers made from the Old Fund to the General Fund mandated by HB363, see the discussion under the Other Non-operating Revenue and Expenses in the Results of Operations – Old Fund section. The net assets also include an unrealized loss of (\$1.2M) for fiscal year 2005 compared to an unrealized loss of (\$3.8M) for fiscal year 2004. This does not indicate that the Old Fund does not have adequate financial resources to satisfy current claims obligations. Applying the current actuarially estimated payout pattern of the Old Fund there is sufficient invested assets to meet its obligations until the year 2014. At that time current law would require the General Fund to satisfy all outstanding claims when the Old Fund has liquidated all financial resources and cannot meet its obligations. Net assets are restricted by the estimated amount of the next fiscal year's transfer to the State of Montana, General Fund. There was no amount to transfer to the State of Montana, General Fund for both 2005 and 2004.

## **Results of Operations – Old Fund**

### Investment-Related Revenue

In fiscal year 2005, there was investment income of \$2.0M compared to an investment loss of (\$105K) in fiscal year 2004. The increase of \$2.1M is mainly due to a lower unrealized loss of (\$1.2M) in 2005 when compared to an unrealized loss of (\$3.8M) in 2004.

### Other Non-operating Revenue and Expenses

House Bill Number 363 (HB 363) was enacted by the 2003 Montana Legislature and changed the existing law regulating the Old Fund transfer of surplus. HB 363 removed the 10% contingency reserve requirement for the Old Fund and transfers the excess available funds from Old Fund to the State of Montana General Fund. In fiscal year 2005, there were no excess funds, therefore \$0 was transferred from Old Fund to the State of Montana, General Fund. In fiscal year 2004, the amount transferred from Old Fund to the State of Montana, General Fund was \$816K.

### Operating Expenses

State law (Section 39-71-2352, MCA) requires MSF to separately determine and account for administrative expenses and benefit payments for claims for injuries resulting from accidents occurring before July 1, 1990 (Old Fund) from those occurring on or after July 1, 1990 (MSF). The law also limits annual administrative costs of claims associated with the Old Fund to \$1.25M for both fiscal years 2005 and 2004. MSF allocated \$1.25M in administration costs to the Old Fund in fiscal years 2005 and 2004. The Old Fund has an \$893K obligation to MSF in un-recovered administrative costs incurred in fiscal years 2005 and prior. MSF intends to recover this amount in future years where the cost of administering the Old Fund is less than the statutorily permitted \$1.25M.

#### *Change in Net Assets*

The change in net assets for fiscal year 2005 is a reduction of \$8.2M compared to a decrease of \$13.6M in fiscal year 2004. The primary reason for this decrease is the continuing development on remaining loss reserves increasing the estimated amount remaining to be paid on outstanding claims. The decreases in net assets have left a deficit in the net assets account of (\$15.6M).

**MONTANA STATE FUND - NEW FUND**  
**STATEMENT OF NET ASSETS**  
*Montana State Fund is a component unit of the State of Montana*

JUNE 30,	<u>2005</u>	<u>2004</u>
<b>ASSETS</b>		
Current Assets		
Cash and cash equivalents	32,157,357	20,685,046
Receivables, net	12,929,765	12,823,616
Due from primary government	1,565	997
Due from component units	702,247	531,041
Securities lending collateral	101,859,456	141,060,425
Other assets	<u>8,428,725</u>	<u>2,038,048</u>
Total Current Assets	156,079,115	177,139,173
Noncurrent Assets		
Investments	656,029,020	582,067,623
Notes and loans receivable	35,998	37,198
Equipment	2,988,734	3,135,509
Accumulated depreciation	(1,978,512)	(1,928,362)
Intangible assets	<u>3,680,005</u>	<u>1,142,019</u>
Total Noncurrent Assets	<u>660,755,245</u>	<u>584,453,987</u>
<b>Total Assets</b>	<u><u>816,834,360</u></u>	<u><u>761,593,160</u></u>
<b>LIABILITIES</b>		
Current Liabilities		
Accounts payable	13,690,027	8,156,787
Due to primary government	1,071,878	1,223,182
Due to component units	211,852	62,534
Estimated claims payable	110,866,995	99,731,000
Compensated absences	1,007,739	1,013,157
Lease payable	-	-
Securities lending liability	101,859,456	141,060,425
Deferred revenue	4,925,828	5,977,233
Property held in trust	<u>13,055,107</u>	<u>8,513,185</u>
Total Current Liabilities	246,688,882	265,737,503
Noncurrent Liabilities		
Estimated claims payable	400,690,005	352,384,000
Compensated absences	780,872	699,479
Lease payable	<u>-</u>	<u>-</u>
Total Noncurrent Liabilities	<u>401,470,877</u>	<u>353,083,479</u>
<b>Total Liabilities</b>	<u><u>648,159,759</u></u>	<u><u>618,820,982</u></u>
<b>NET ASSETS</b>		
Invested in capital assets, net of related debt	4,690,227	2,349,166
Unrestricted	<u>163,984,374</u>	<u>140,423,012</u>
<b>Total Net Assets</b>	168,674,601	142,772,178
<b>Total Liabilities and Net Assets</b>	<u><u>816,834,360</u></u>	<u><u>761,593,160</u></u>

The notes to the financial statements are an integral part of this statement.



**MONTANA STATE FUND - NEW FUND**  
**STATEMENT OF REVENUES, EXPENSES, and CHANGES IN FUND NET ASSETS**  
*Montana State Fund is a component unit of the State of Montana*

YEARS ENDED JUNE 30,	<u>2005</u>	<u>2004</u>
Net premiums earned	189,378,858	139,360,612
Operating Expenses		
Benefits and claims	159,612,313	139,232,097
Personal services	17,168,457	15,379,088
Contractual services	12,029,017	11,956,710
Supplies and materials	867,005	745,190
Depreciation	455,407	520,500
Amortization	407,105	1,144,444
Rent and utilities	305,923	229,056
Communications	1,116,449	1,178,257
Travel	211,673	181,419
Repair and maintenance	863,245	440,180
Interest expense	-	-
Other operating expenses	<u>2,500,685</u>	<u>3,059,447</u>
Total Operating Expenses	<u>195,537,279</u>	<u>174,066,388</u>
Operating Loss	<u>(6,158,421)</u>	<u>(34,705,776)</u>
Nonoperating Revenue (Expenses)		
Investment income	35,920,969	14,994,923
Gains on investments	1,118,749	1,845,426
Securities lending income	2,438,833	938,947
Losses on investments	(76,863)	(742,294)
Securities lending expense	(2,341,264)	(846,168)
Royalties	-	91,124
Penalties and interest	15,270	13,186
Payment from Old Fund	-	-
Payment to State of Montana	-	(10,218)
Loss on retirement of assets	(46,532)	(10,485)
Dividend expense	(5,004,416)	(1,909,856)
Other income	<u>36,098</u>	<u>19,554</u>
Total Nonoperating Revenue (Expense)	<u>32,060,844</u>	<u>14,384,139</u>
Change in Net Assets	25,902,423	(20,321,637)
Total Net Assets - Beginning	<u>142,772,178</u>	<u>163,093,815</u>
Total Net Assets - Ending	<u><u>168,674,601</u></u>	<u><u>142,772,178</u></u>

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**MONTANA STATE FUND - NEW FUND**  
**STATEMENT OF CASH FLOWS**  
*Montana State Fund is a component unit of the State of Montana*

YEARS ENDED JUNE 30,	2005	2004
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Receipts for premiums	188,037,127	148,065,720
Payments to suppliers for goods and services	(15,876,315)	(17,965,050)
Payments to employees	(15,944,599)	(14,913,111)
Cash payments for claims	(103,573,355)	(98,956,660)
Other operating receipts	51,368	(19,330)
Other operating payments	-	-
Net Cash Provided by (Used for) Operating Activities	52,694,226	16,211,569
<b>CASH FLOWS FROM NONCAPITAL FINANCIAL ACTIVITIES</b>		
Payment of Dividends to Policyholders	(5,004,416)	(1,909,856)
Payment to State of Montana	-	(10,218)
Net Cash Provided by (Used for) Noncapital Financing Activities	(5,004,416)	(1,920,074)
<b>CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES</b>		
Acquisition of fixed assets	(2,721,963)	(1,458,613)
Proceeds from sale of fixed assets	-	125,278
Net Cash Used for Capital and Related Financing Activities	(2,721,963)	(1,333,335)
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Purchase of investments	(155,380,802)	(148,909,900)
Proceeds from sales or maturities of investments	91,939,366	97,157,279
Proceeds from securities lending transactions	2,438,833	938,947
Payments of security lending costs	(2,247,180)	(772,214)
Interest and dividends on investments	29,754,247	27,172,131
Net Cash Provided by (Used For) Investing Activities	(33,495,536)	(24,413,757)
<b>NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS</b>	11,472,311	(11,455,597)
<b>CASH AND CASH EQUIVALENTS - JULY 1</b>	20,685,046	32,140,643
<b>CASH AND CASH EQUIVALENTS - JUNE 30</b>	32,157,357	20,685,046

**MONTANA STATE FUND - NEW FUND**  
**STATEMENT OF CASH FLOWS**  
*Montana State Fund is a component unit of the State of Montana*

YEARS ENDED JUNE 30,	<u>2005</u>	<u>2004</u>
<b>RECONCILIATION OF CHANGE IN NET ASSETS TO NET CASH PROVIDED BY (USED FOR) OPERATING ACTIVITIES</b>		
Change in Net Assets	25,902,423	(20,321,637)
<b>Adjustments to Reconcile Change in Net Assets to Net Cash Provided by (Used for) Operating Activities</b>		
Depreciation	455,407	520,500
Amortization	407,105	1,144,444
Interest expense	-	-
Security lending costs	2,341,264	846,168
Security lending income	(2,438,833)	(938,947)
Interest on investment	(36,962,854)	(16,098,055)
Payments of Dividends to Policyholders	5,004,416	1,909,856
Payment to State of Montana	-	10,218
Decrease (increase) in		
Accounts receivable	580,062	(1,013,293)
Due from component units	(150,062)	(345,324)
Notes receivable	1,200	36,143
Other assets	(6,344,145)	320,039
Increase (decrease) in		
Accounts payable	889,278	1,195,920
Due to primary government	473	146,418
Deferred revenue	(1,051,405)	5,774,321
Property held in trust	4,541,922	4,015,088
Estimated claims	59,442,000	38,715,000
Lease payable	-	-
Compensated absences	75,975	294,710
Total adjustments	26,791,803	36,533,206
<b>Net Cash Provided by (Used for) Operating Activities</b>	<u>52,694,226</u>	<u>16,211,569</u>

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**MONTANA STATE FUND - OLD FUND**  
**STATEMENT OF NET ASSETS**  
*Montana State Fund is a component unit of the State of Montana*

JUNE 30,	<u>2005</u>	<u>2004</u>
<b>ASSETS</b>		
Current Assets		
Cash and cash equivalents	12,207,312	4,113,840
Receivables, net	704,270	1,089,275
Due from component units	211,852	62,534
Securities lending collateral	<u>17,768,750</u>	<u>13,248,863</u>
Total Current Assets	30,892,184	18,514,512
Noncurrent Assets		
Investments	<u>51,353,489</u>	<u>69,215,594</u>
<b>Total Assets</b>	<u><u>82,245,673</u></u>	<u><u>87,730,106</u></u>
<b>LIABILITIES</b>		
Current Liabilities		
Accounts payable	246,061	613,607
Due to primary government	851	1,387
Due to component units	702,247	531,041
Estimated claims payable	10,321,720	14,409,000
Compensated absences	-	-
Deferred revenue	-	-
Securities lending liability	<u>17,768,750</u>	<u>13,248,863</u>
Total Current Liabilities	29,039,629	28,803,898
Noncurrent Liabilities		
Estimated claims payable	68,787,280	66,369,000
Compensated absences	<u>-</u>	<u>-</u>
Total Noncurrent Liabilities	<u>68,787,280</u>	<u>66,369,000</u>
<b>Total Liabilities</b>	<u>97,826,909</u>	<u>95,172,898</u>
<b>NET ASSETS</b>		
Restricted	-	-
Unrestricted	<u>(15,581,236)</u>	<u>(7,442,792)</u>
<b>Total Net Assets</b>	<u>(15,581,236)</u>	<u>(7,442,792)</u>
<b>Total Liabilities and Net Assets</b>	<u><u>82,245,673</u></u>	<u><u>87,730,106</u></u>

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**MONTANA STATE FUND - OLD FUND**  
**STATEMENT OF REVENUES, EXPENSES, and CHANGES IN FUND NET ASSETS**  
*Montana State Fund is a component unit of the State of Montana*

<b>YEARS ENDED JUNE 30,</b>	<u><b>2005</b></u>	<u><b>2004</b></u>
Operating Expenses		
Benefits and claims	8,670,528	11,558,899
Personal services	13,279	21,126
Contractual services	987,022	1,024,608
Depreciation	32,205	86,639
Amortization	166,368	90,220
Other operating expenses	<u>239,817</u>	<u>353,838</u>
Total Operating Expenses	<u>10,109,219</u>	<u>13,135,330</u>
Operating Loss	<u>(10,109,219)</u>	<u>(13,135,330)</u>
Nonoperating Revenue (Expenses)		
Investment income	1,964,720	(104,724)
Gains on investments	22,522	335,941
Securities lending income	454,567	118,563
Losses on investments	(25,237)	(479)
Securities lending expense	(445,751)	(104,076)
Payment to State of Montana	-	(815,605)
Payment to New Fund	-	-
Liability tax revenue	<u>(46)</u>	<u>68,127</u>
Total Nonoperating Revenue (Expenses)	<u>1,970,775</u>	<u>(502,253)</u>
Change in Net Assets	(8,138,444)	(13,637,583)
Total Net Assets - Beginning	(7,442,792)	6,194,791
Prior Period Adjustment	-	-
Total Net Assets - Ending	<u><u>(15,581,236)</u></u>	<u><u>(7,442,792)</u></u>

**MONTANA STATE FUND - OLD FUND**  
**STATEMENT OF CASH FLOWS**  
*Montana State Fund is a component unit of the State of Montana*

<b>YEARS ENDED JUNE 30,</b>	<u><b>2005</b></u>	<u><b>2004</b></u>
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Payments to suppliers for goods and services	(1,417,339)	(1,294,235)
Payments to employees	-	
Cash payments for claims	(10,732,998)	(11,656,177)
Collection of payroll taxes	<u>4,985</u>	<u>37,881</u>
Net Cash Used for Operating Activities	(12,145,352)	(12,912,531)
<b>CASH FLOWS FROM NONCAPITAL FINANCIAL ACTIVITIES</b>		
Payment to State of Montana	-	(815,605)
Payment to New Fund	<u>-</u>	<u>-</u>
Net Cash Used for Noncapital Financing Activities	-	(815,605)
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Purchase of investments	(17,976,764)	(15,568,930)
Proceeds from sales or maturities of investments	34,403,997	24,292,805
Proceeds from securities lending transactions	454,567	118,563
Payments of security lending costs	(412,094)	(95,863)
Interest and dividends on investments	<u>3,769,118</u>	<u>4,351,905</u>
Net Cash Provided by Investing Activities	<u>20,238,824</u>	<u>13,098,480</u>
<b>NET DECREASE IN CASH AND CASH EQUIVALENTS</b>	8,093,472	(629,656)
<b>CASH AND CASH EQUIVALENTS - JULY 1</b>	<u>4,113,840</u>	<u>4,743,496</u>
<b>CASH AND CASH EQUIVALENTS - JUNE 30</b>	<u><u>12,207,312</u></u>	<u><u>4,113,840</u></u>

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**MONTANA STATE FUND - OLD FUND**  
**STATEMENT OF CASH FLOWS**  
*Montana State Fund is a component unit of the State of Montana*

YEARS ENDED JUNE 30,	<u>2005</u>	<u>2004</u>
<b>RECONCILIATION OF CHANGE IN NET ASSETS TO NET CASH USED FOR OPERATING ACTIVITIES</b>		
Change in Net Assets	(8,138,444)	(13,637,583)
<b>Adjustments to Reconcile Change in Net Assets to Net Cash Used for Operating Activities</b>		
Security lending costs	445,751	104,076
Security lending income	(454,567)	(118,563)
Interest on investment	(1,962,005)	(230,738)
Payment to State of Montana	-	815,605
Payment to New Fund		
Prior period adjustment for payroll taxes		
Decrease (increase) in		
Accounts receivable	12,763	34,290
Due from primary government	(149,318)	(62,534)
Increase (decrease) in		
Accounts payable	(401,202)	(40,506)
Due to component units	170,670	345,422
Deferred revenue	-	-
Estimated claims	<u>(1,669,000)</u>	<u>(122,000)</u>
Total adjustments	(4,006,908)	725,052
<b>Net Cash Used for Operating Activities</b>	<u><u>(12,145,352)</u></u>	<u><u>(12,912,531)</u></u>

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**Montana State Fund**  
(A Component Unit of the State of Montana)  
Notes to Financial Statements  
June 30, 2005 and 2004

**1. Summary of Significant Accounting Policies**

**Description of Business**

The Montana State Fund (MSF) is a nonprofit, quasi-public entity established under Title 39, chapter 71 of the Montana Code Annotated (MCA). MSF provides Montana employers with an option for workers' compensation and occupational disease insurance and guarantees available coverage for all employers in Montana. MSF is governed by a seven member Board of Directors appointed by the Governor. MSF is attached to the State of Montana, Department of Administration for administrative purposes only.

During the 1990 Montana Special Legislative Session, legislation passed establishing separate funding and accounts for claims of injuries resulting from accidents occurring before July 1, 1990, referred to as the Old Fund, and claims occurring on or after July 1, 1990, referred to as MSF. Hereafter, any reference to MSF refers to the New Fund or those claims occurring after July 1, 1990.

MSF functions as an autonomous insurance entity supported solely from its own revenues. All assets, debts, and obligations of MSF are separate and distinct from assets, debts, and obligations of the State of Montana. If MSF is dissolved by an act of law, the money in MSF is subject to the disposition provided by the legislature enacting the dissolution with due regard given to obligations incurred and existing (Section 39-71-2322, MCA). MSF administers and manages the claims remaining in the Old Fund for the State of Montana and is the administering entity for recording the financial activity related to receipt and disbursement of an Old Fund Liability Tax (see Note 4). No State general fund money is used for MSF operations.

MSF financial statements are presented as a component unit in the State of Montana Comprehensive Annual Financial Report. The fiscal year 2005 and 2004 financial statements are presented in conformance with Governmental Accounting Standards Board Statement 34, which is a comparable format to the State of Montana Comprehensive Annual Financial Report.

**Basis of Accounting**

MSF uses the accrual basis of accounting, as defined by generally accepted accounting principles, for its workers' compensation insurance operations. Under the accrual basis, MSF records revenues in the accounting period earned, if measurable, and records expenses in the period incurred, if measurable.

**Cash and Cash Equivalents**

Cash balances include demand deposits with the State Treasury. Cash equivalents are short-term, highly liquid investments that are both readily convertible to known amounts of cash and so near



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**Montana State Fund**  
(A Component Unit of the State of Montana)  
Notes to Financial Statements  
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their maturity that they present insignificant risk of changes in value because of changes in interest rates. MSF participates in the Montana Board of Investments Short Term Investment Pool (STIP). STIP balances are highly liquid investments with maturities of 397 days or less with the exception of securities having rate reset dates. There are no legal risks that the Montana Board of Investments (BOI) is aware of regarding any STIP investments. The STIP portfolio is carried at amortized cost or book value with market value approximating cost. MSF's STIP balance of \$29.5M as of June 30, 2005 represents 1.69% of the total STIP. The Old Fund STIP balance of \$11.6M as of June 30, 2005 represents 0.67% of the total STIP. MSF's STIP balance of \$18.2M as of June 30, 2004 represents 1.23% of the total STIP. The Old Fund STIP balance of \$3.7M as of June 30, 2004 represents 0.25% of the total STIP.

The STIP investments' credit risk is measured by investment grade ratings given individual securities. The BOI's policy requires that STIP investments have the highest rating in the short-term category by one and/or any Nationally Recognized Statistical Rating Organizations (NRSRO). The four NRSRO's include Standard and Poor's, Moody's Investors Service, Fitch, Inc. and Dominion Bond Rating Service Ltd.

Asset-backed securities constitute 71.72% of the BOI's total STIP portfolio as of June 30, 2005. Asset-backed securities have less credit risk than do securities not backed by pledged assets. Market risk for asset-backed securities is the same as market risk for similar non asset-backed securities. Asset-backed securities constitute 63.58% of the Board of Investment's total STIP portfolio as of June 30, 2004.

Variable rate (floating rate) securities make up 24.16% of the BOI's total STIP portfolio as of June 30, 2005. Variable rate securities make up 34.12% of the BOI's total STIP portfolio as of June 30, 2004. While variable rate securities have credit risk identical to similar fixed rate securities, their market risk (income) is more sensitive to interest rate changes. However, the market risk (value/price) may be less volatile than fixed rate securities because their value will usually remain at or near par as a result of their interest rates being periodically reset to maintain a current market yield.

#### Investments

In addition to STIP investments, MSF invests in long-term securities with the BOI. Under the provisions of the state constitution, MSF's invested assets are managed by the BOI. Securities are stated at fair value as defined and required by Governmental Accounting Standards Board (GASB) Statement Number 31, "Accounting and Financial Reporting for Certain Investments and for External Investment Pools". Premiums and discounts are amortized using the straight-line method over the life of the securities. Net unrealized gains or losses on securities are included in net income in accordance with GASB 31.

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**Montana State Fund**  
(A Component Unit of the State of Montana)  
Notes to Financial Statements  
June 30, 2005 and 2004

Effective June 30, 2005, the BOI implemented the provisions of Governmental Accounting Standards Board (GASB) Statement No. 40 "Deposit and Investment Risk Disclosures". The financial statement disclosures for the year ended June 30, 2004 have been restated to compare with the financial statement disclosures for the year ended June 30, 2005. The investment risk disclosures are described in the following paragraphs.

Credit Risk

Credit risk is defined as the risk that an issuer or other counterparty to an investment will not fulfill its obligation. With the exception of the U.S. government securities, the All Other Fund (AOF) fixed income instruments have credit risk as measured by major credit rating services. This risk is that the issuer of a fixed income security may default in making timely principal and interest payments. The Board of Investment's policy requires New Fund and Old Fund fixed income investments, at the time of purchase, to be rated an investment grade as defined by Moody's and/or Standard & Poor's (S&P) rating services. The U.S. government securities are guaranteed directly or indirectly by the U.S. government. Obligations of the U.S. government or obligations explicitly guaranteed by the U.S. government are not considered to have credit risk and do not require disclosure of credit quality. The credit ratings presented in the following table are provided by S&P's rating services. If an S&P rating is not available, a Moody's rating has been used.

Custodial Credit Risk

Custodial credit risk for investments is the risk that, in the event of the failure of the counterparty to a transaction, a government will not be able to recover the value of the investment or collateral securities that are in the possession of an outside party. As of June 30, 2005 and 2004, all the fixed income and other equity securities were registered in the nominee name for the Montana Board of Investments and held in the possession of the Board's custodial bank, State Street Bank. The Equity Index investment and State Street Bank repurchase agreement were purchased in the State of Montana Board of Investments name.

Concentration of Credit Risk

Concentration of credit risk is the risk of loss attributed to the magnitude of a government's investment in a single issuer. The New Fund Investment Policy, requires credit risk to be limited to 3 percent in any one name except AAA rated issues will be limited to 6% while the Old Fund investment policy statement does not address concentration of credit risk. The New Fund Investment Policy provides for "no limitation on U.S. government/agency securities". Investments issued or explicitly guaranteed by the U.S. government are excluded from the concentration of credit risk requirement.

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**Montana State Fund**  
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For fiscal year 2005, New Fund had concentration of credit risk exposure to the Federal Home Loan Mortgage Corp of 5.43% and Federal National Mortgage Association of 11.75%. For fiscal year 2004, New Fund only had concentration of credit risk exposure of 10.74% to the Federal National Mortgage Association.

For fiscal year 2005, Old Fund had concentration of credit risk exposure to the Federal Home Loan Mortgage Corp of 7.89% and Federal National Mortgage Association of 24.78%. For fiscal year 2004, New Fund had concentration of credit risk exposure to the Federal National Mortgage Association of 21.96% and JP Morgan Chase Commercial Mortgage of 6.56%.

Interest Rate Risk

Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of an investment. The New Fund and Old Fund investment policies do not formally address interest rate risk. In accordance with GASB Statement No. 40, the Board has selected the effective duration method to disclose interest rate risk. This method, as provided by our custodial bank, is "An option-adjusted measure of a bond's (or portfolio's) sensitivity to changes in interest rates. Duration is calculated as the average percentage change in a bond's value (price plus accrued interest) under shifts of the Treasury curve plus/minus 100 basis points. The effective duration method incorporates the effect of the embedded options for bonds and changes in prepayments for mortgage-backed securities (including pass-throughs, Collateralized Mortgage Obligations (CMO's) and Adjustable Rate Mortgages (ARM's))."

As of June 30, 2005, the New Fund and Old Fund portfolios did not hold any structured financial instruments known as REMICs (Real Estate Mortgage Investment Conduits). REMICs are pass-through vehicles for multiclass mortgage-backed securities. Strip investments represent the separate purchase of the principal and interest cash flows of a mortgage security. As of June 30, 2004, the New Fund and the Old Fund portfolios held a REMIC with an amortized cost of \$8,658,861 and \$4,329,430, respectively, as reported in the U.S. government mortgage-backed category. This security paid off in March 2005. The REMIC securities are based on separate or combined cash flows from principal and interest payments on underlying mortgages. When underlying mortgages are prepaid, the interest cash flows are reduced while principal cash flows are increased. If homeowners pay on mortgages longer than anticipated, the cash flow effect would be the opposite.

Corporate asset-backed securities are based on cash flows from principal and interest payments on underlying auto loan receivables, credit card receivables, and other assets. These securities, while sensitive to prepayments due to interest rate changes, have less credit risk than securities not backed by pledged assets.

New Fund and Old Fund investments are categorized below to disclose credit and interest rate

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**Montana State Fund**  
(A Component Unit of the State of Montana)  
Notes to Financial Statements  
June 30, 2005 and 2004

risk as of June 30, 2005 and June 30, 2004. Credit risk reflects the bond quality rating, by investment type, as of the June 30 report date. If a bond investment type is unrated, the quality type is indicated by NR (not rated). Interest rate risk is disclosed using effective duration. Both the credit quality ratings and duration have been calculated excluding cash equivalents.

**Credit Quality Rating and Effective Duration as of June 30, 2005**

<u>Security Investment Type</u>	<u>Fair Value</u>	<u>Credit Quality Rating</u>	<u>Effective Duration</u>
Corporate Bonds (Rated)	\$ 299,185,736	A	4.84
U.S. Govt Direct-Backed	17,805,771	AAA	7.45
U.S. Govt Indirect-Backed	259,195,259	AAA	3.67
State Street Repo* (Rated)	3,105,156	AA-	NA
STIP (Unrated)	<u>29,462,578</u>	<u>NR</u>	NA
Total Fixed Income Investments	608,754,500		
<u>Direct Investments</u>			
Equity Index Fund	\$ <u>76,737,097</u>		
Total Investments	\$ <u>685,491,597</u>	<u>AA-</u>	<u>4.39</u>
Securities Lending Collateral Investment Pool	\$ <u>101,859,456</u>	NR	NA

\* At June 30, 2005, the State Street Bank repurchase agreement was collateralized at \$3,182,153 a Federal Home Loan Mortgage Corporation note maturing February 15, 2006.

**Credit Quality Rating and Effective Duration as of June 30, 2004**

<u>Security Investment Type</u>	<u>Fair Value</u>	<u>Credit Quality Rating</u>	<u>Effective Duration</u>
Corporate Bonds (Rated)	\$ 281,014,259	A	4.57
U.S. Govt Direct-Backed	33,858,050	AAA	4.48
U.S. Govt Indirect-Backed	195,056,940	AAA	4.78
STIP (Unrated)	<u>18,207,649</u>	<u>NR</u>	NA
Total Fixed Income Investments	528,136,898		
<u>Direct Investments</u>			
Equity Index Fund	\$ <u>72,138,374</u>		
Total Investments	\$ <u>600,275,272</u>	<u>AA-</u>	<u>4.64</u>
Securities Lending Collateral Investment Pool	\$ <u>141,060,425</u>	NR	NA



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**Montana State Fund**  
(A Component Unit of the State of Montana)  
Notes to Financial Statements  
June 30, 2005 and 2004

**Old Fund Credit Quality Rating and Effective Duration as of June 30, 2005**

<u>Security Investment Type</u>	<u>Fair Value</u>	<u>Credit Quality Rating</u>	<u>Effective Duration</u>
Corporate Bonds (Rated)	\$ 8,174,889	BBB+	0.96
U.S. Govt Direct-Backed	15,927,393	AAA	2.04
U.S. Govt Indirect-Backed	26,216,154	AAA	1.56
State Street Repo (Rated)*	1,035,052	AA-	NA
STIP (Unrated)	<u>11,599,288</u>	<u>NR</u>	<u>NA</u>
<b>Total Investments</b>	<b>\$ <u>62,952,776</u></b>	<b><u>AA+</u></b>	<b><u>1.62</u></b>
<b>Securities Lending Collateral Investment Pool</b>	<b>\$ <u>17,768,750</u></b>	<b>NR</b>	<b>NA</b>

\* At June 30, 2005, the State Street Bank repurchase agreement was collateralized at \$1,060,718 by a Federal Home Loan Mortgage Corporation note maturing February 15, 2006.

**Old Fund Credit Quality Rating and Effective Duration as of June 30, 2004**

<u>Security Investment Type</u>	<u>Fair Value</u>	<u>Credit Quality Rating</u>	<u>Effective Duration</u>
Corporate Bonds (Rated)	\$ 18,925,865	A+	1.82
U.S. Govt Direct-Backed	28,653,821	AAA	4.29
U.S. Govt Indirect-Backed	21,635,908	AAA	2.37
STIP (Unrated)	<u>3,682,851</u>	<u>NR</u>	<u>NA</u>
<b>Total Investments</b>	<b>\$ <u>72,898,445</u></b>	<b><u>AA+</u></b>	<b><u>3.02</u></b>
<b>Securities Lending Collateral Investment Pool</b>	<b>\$ <u>13,248,863</u></b>	<b>NR</b>	<b>NA</b>

MSF investments are classified in risk Category 1 or as Not Categorized under State of Montana standards. Risk category 1 includes investments that are insured or registered, or securities held by the BOI or its agent in the BOI's name. Not Categorized includes investments held by broker-dealers under securities loans with cash collateral.

Under the provisions of state statutes, the BOI has, by a Securities Lending Authorization Agreement, authorized the custodial bank, State Street Bank (SSB), to lend the BOI's securities to broker-dealers and other entities with a simultaneous agreement to return the collateral for the same

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securities in the future. During the period the securities are on loan, the BOI receives a fee and the custodial bank must initially receive collateral equal to 102% of the fair value of the securities on loan and must maintain collateral equal to but not less than 100% of the fair value of the loaned security. The BOI retains all rights and risks of ownership during the loan period.

The cash collateral received on each loan was invested, together with the cash collateral of other qualified plan lenders, in a collective investment pool, the Securities Lending Quality trust. The relationship between the average maturities of the investment pool and the BOI's loans was affected by the maturities of the loans made by other plan entities that invested cash collateral in the collective investment pool, which the BOI could not determine. On June 30, 2005 and June 30, 2004, the BOI had no credit risk exposure to borrowers.

The following table presents the carrying and market values of the securities on loan and the total cash collateral held for fiscal years ended June 30, 2005 and June 30, 2004 for both MSF and the Old Fund:

	<b>MSF</b>		<b>Old Fund</b>	
	<b>Fiscal Year</b>	<b>Fiscal Year</b>	<b>Fiscal Year</b>	<b>Fiscal Year</b>
	<b>2005</b>	<b>2004</b>	<b>2005</b>	<b>2004</b>
<b>Securities on Loan-Book Value</b>	\$115,170,586	\$134,808,112	\$17,158,630	\$14,099,489
<b>Securities on Loan-Market Value</b>	\$99,953,577	\$137,258,780	\$17,422,180	\$14,210,615
<b>Total Collateral Held</b>	\$101,859,456	\$141,060,425	\$17,768,750	\$13,248,863

As of June 30, 2005, MSF and the Old Fund investments include \$115.2M and \$17.2M respectively, in long-term securities on loan that earned interest income during the fiscal year of \$2.4M and \$455K respectively.

As of June 30, 2004, MSF and the Old Fund investments include \$134.8M and \$14.1M respectively, in long-term securities on loan that earned interest income during the fiscal year of \$939K and \$119K respectively.

In November 2000, the Montana Constitution was amended to allow investing in equity securities, with the restriction that equity securities cannot exceed 25% of total investment book value. However, in May 2003, the BOI approved a policy statement to keep equities in the 8% to 12% range. As of June 30, 2005, equity securities in MSF include \$68.4M at book value, enhanced by \$8.3M in market value appreciation. As of June 30, 2004, equity securities in MSF include

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\$68.4M at book value, enhanced by \$3.7M in market value appreciation.

Additional investment information can be found in Note 2.

Receivables

At June 30, 2005, MSF's premium receivable balance is \$5.3M, which is then reduced by estimated uncollectible receivables reported as an allowance for doubtful accounts of \$726K leaving a net receivable balance of \$4.6M. Other receivables include \$8.2M in investment income due and \$146K in notes and loans receivable, of which \$36K is long term.

At June 30, 2004, MSF's premium receivable balance is \$5.8M, which is then reduced by estimated uncollectible receivables reported as an allowance for doubtful accounts of \$598K leaving a net receivable of \$5.2M. Other receivables include \$7.5M in investment income due and \$142K in notes and loans receivable, of which \$37K is long term.

Accounts receivable in the Old Fund include medical overpayments and remaining receivables from the Old Fund Liability Tax collections. Net accounts receivable for year ended June 30, 2005 and June 30, 2004 were \$51K and \$64K, respectively. Estimated uncollectible receivables are reported as an allowance for doubtful accounts. Interest receivable of \$653K at June 30, 2005 and \$1.0M at June 30, 2004 represents investment income due.

Equipment, Accumulated Depreciation and Intangible Assets

Equipment is capitalized if the actual or estimated historical cost exceeds \$5K. Depreciation expense is computed on a straight-line basis for equipment over a period of three to five years and amortization of intangible assets is computed on a straight-line basis over five years. Amortization of intangible assets is applied directly to the asset balance. All fixed assets are recorded in the MSF financials. Because MSF administers the Old Fund, the Old Fund does not carry fixed assets.

Other Assets

Other assets include advances, prepaid expenses and deferred acquisition costs. Deferred acquisition cost are amounts incurred during the policy writing process that are recognized ratably over the related policy term.

Estimated Claims Payable

The estimated claims payable is established to provide for the estimated ultimate settlement cost of all claims incurred. Estimated claims payable is based on reported aggregate claim cost

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estimates combined with estimates for future development of such claim costs and estimates of incurred but not reported (IBNR) claims. Tillinghast-Towers Perrin, an external actuarial firm, prepares an actuarial study that provides a range of potential cost associated with reported claims, the future development of those claims and IBNR. MSF management has selected the best estimates within that range as the estimated claims payable for both MSF and Old Fund. For additional disclosure related to the estimated claims payable, refer to Note 4.

Accounts Payable

Accounts payable is a short term liability account reflecting amounts owed for goods and services received by MSF.

Deferred Revenue

Deferred revenue reflects amounts received or billed in advance, but not yet earned for policies effective July 1, 2005 or July 1, 2004.

Property Held in Trust

Property Held in Trust consists of security deposits owed to certain policyholders and the reinsurance funds withheld account, a requirement of MSF's aggregate stop loss reinsurance contract. Additional information regarding the funds withheld account can be found in Note 3.

Net Assets

Net assets consist of the net excess or deficit of assets over liabilities. For additional information on distributions impacting total net assets see Note 6.

Premiums

The MSF Board of Directors approves premium rates annually. Generally, policies are effective for the term of the policy period not to exceed 12 months. Premium revenue is recognized over the term of the fiscal year, which runs from July 1 through June 30, as it is earned or when MSF is liable for coverage.

Policyholders are contractually obligated to pay certain premiums to MSF in advance of the period the premiums are earned. Premium advances are refundable when the policyholder's coverage is canceled and all earned premiums have been credited by MSF.

Basis of Presentation



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The financial statements are presented in accordance with generally accepted accounting principles as prescribed by the Governmental Accounting Standards Board. MSF insurance operations are classified as an enterprise fund, proprietary fund type. MSF comprises only a part of the State of Montana's enterprise funds. The financial statements in this report reflect the financial position and results of operations and cash flows of MSF and Old Fund, not the State of Montana.

An enterprise fund is used to account for operations: (a) financed and operated in a manner similar to private business enterprises, where the legislature intends that the entity finance or recover costs primarily through user charges; (b) where the legislature has decided that periodic determination of revenues earned, expenses incurred or net income is appropriate; (c) where the activity is financed solely by a pledge of the net revenues from fees and charges of the activity; (d) when laws or regulations require that the activities' costs of providing services be recovered with fees and charges rather than with taxes or similar revenues.

Investments are presented in accordance to GASB Statement Number 31, "Accounting and Financial Reporting for Certain Investments and External Investment Pools." STIP is considered an external investment pool, which is defined as an arrangement that pools the monies of more than one legally separate entity and invests, on the participant's behalf, in an investment portfolio. STIP is also classified as a "2a7-like" pool. A 2a7-like pool is an external investment pool that is not registered with the Securities and Exchange Commission (SEC) as an investment company, but has a policy that it will, and does, operate in a manner consistent with the SEC's Rule 2a7 of the Investment Company Act of 1940. If certain conditions are met, 2a7-like pools are allowed to use amortized cost rather than fair value to report net assets to compute unit values. The BOI has adopted a policy to treat STIP as a 2a7-like pool. See Note 1, Basis of Accounting – Investments and Note 2 for further discussions of the effect of GASB 31.

## **2. Investments**

The amortized cost and market value of MSF's fixed maturity securities as of June 30, 2005, and June 30, 2004, are as follows:

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		<u>Gross Unrealized</u>		
<b>June 30, 2005</b>	<u>Amortized Cost</u>	<u>Gain</u>	<u>Loss</u>	<u>Market Value</u>
Government Direct-Indirect	\$ 244,379,693	\$ 6,332,933	\$ 628,853	\$ 250,083,773
Government Mortgage-Backed	26,134,547	782,710	0	26,917,257
Corporate Securities Asset-Backed	24,310,182	0	312,525	23,997,657
Other Corporate Securities	256,757,099	8,848,355	2,892,808	262,712,646
Other Securities	11,951,816	525,794	2177	12,475,433
Equity Securities	68,406,676	8,330,421	0	76,737,097
STIP (reported as Cash & Cash	32,567,734	0	0	32,567,734
<b>Total</b>	<b>\$ 664,507,747</b>	<b>\$ 24,820,213</b>	<b>\$ 3,836,363</b>	<b>\$ 685,491,597</b>

		<u>Gross Unrealized</u>		
<b>June 30, 2004</b>	<u>Amortized Cost</u>	<u>Gain</u>	<u>Loss</u>	<u>Market Value</u>
Government Direct-Indirect	\$ 182,136,355	\$ 5,413,826	\$ 2,591,072	\$ 184,959,109
Government Mortgage-Backed	43,220,924	1,049,286	314,329	43,955,881
Corporate Securities Asset-Backed	23,105,996	0	247,250	22,858,746
Other Corporate Securities	242,107,218	8,690,647	2,349,713	248,448,152
Other Securities	8,940,976	766,385	0	9,707,361
Equity Securities	68,406,676	3,731,698	0	72,138,374
STIP (reported as Cash & Cash	18,207,649	0	0	18,207,649
<b>Total</b>	<b>\$ 586,125,794</b>	<b>\$ 19,651,842</b>	<b>\$ 5,502,364</b>	<b>\$ 600,275,272</b>

The amortized cost and estimated market value of MSF's fixed maturity securities as of June 30, 2005 and June 30, 2004, are shown below at contractual maturity. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

**June 30, 2005**

	<u>Amortized Cost</u>	<u>Market Value</u>
Due one year or less	\$ 18,584,037	\$ 18,737,683
Due after one year through five years	337,703,075	342,545,705
Due after five years through ten years	172,312,177	177,837,490
Due after ten years	67,501,781	69,633,622
Equity Securities	68,406,676	76,737,097
<b>Total</b>	<b>\$ 664,507,746</b>	<b>\$ 685,491,597</b>

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**June 30, 2004**

	<u>Amortized Cost</u>	<u>Market Value</u>
Due one year or less	\$ 44,573,096	\$ 45,051,831
Due after one year through five years	147,503,678	152,273,132
Due after five years through ten years	230,617,869	234,268,425
Due after ten years	95,024,475	96,543,510
Equity Securities	68,406,676	72,138,374
<b>Total</b>	<u>\$ 586,125,794</u>	<u>\$ 600,275,272</u>

During fiscal year ending June 30, 2005, MSF realized gross gains from sales of securities of \$1.1M and gross realized losses of \$77K. During fiscal year ending June 30, 2004, MSF realized gross gains from sales of securities of \$1.8M and gross realized losses of \$742K.

As discussed in Note 1, GASB 31 requires governmental entities to report their investments at fair value. Fair value is defined as the amount at which an investment could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. The adjustment to fair value is reflected as an increase or decrease in investment income. During fiscal year 2005, investment income for MSF reflects an increase of \$6.8M due to the unrealized gain on long-term investments. Investment income for fiscal year 2004 reflects a decrease of \$11.6M due to the unrealized loss on long-term investments.

The amortized cost and market value of the Old Fund fixed maturity securities as of June 30, 2005 and June 30, 2004 are as follows:

<b>June 30, 2005</b>	<u>Amortized Cost</u>	<u>Gross Unrealized</u>		<u>Market Value</u>
		<u>Gain</u>	<u>Loss</u>	
Government Direct-Indirect	\$ 35,645,353	\$ 493,221	\$ 180,157	\$ 35,958,417
Government Mortgage-Backed	2,415,662	85,099	0	2,500,761
Corporate Securities Asset-Backed	2,680,027	0	79,256	2,600,771
Other Corporate Securities	9,229,047	172,357	142,916	9,258,488
Other Securities				-
STIP (reported as Cash & Cash Equivalents)	12,634,340	0	0	12,634,340
<b>Total</b>	\$ 62,604,429	\$ 750,677	\$ 402,329	\$ 62,952,777



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		Gross Unrealized		
<b>June 30, 2004</b>	<b>Amortized Cost</b>	<b>Gain</b>	<b>Loss</b>	<b>Market Value</b>
Government Direct-Indirect	\$ 41,297,467	\$ 1,313,283	\$ 163,235	\$ 42,447,515
Government Mortgage-Backed	7,825,891	144,119	127,795	7,842,215
Corporate Securities Asset-Backed	4,924,938	0	142,178	4,782,760
Other Corporate Securities	13,605,022	538,082	0	14,143,104
Other Securities	0	0	0	0
STIP (reported as Cash & Cash Equivalents)	3,682,851	0	0	3,682,851
<b>Total</b>	<b>\$ 71,336,169</b>	<b>\$ 1,995,484</b>	<b>\$ 433,208</b>	<b>\$ 72,898,445</b>

The amortized cost and market value of the Old Fund fixed maturity securities as of June 30, 2005 and June 30, 2004 are shown below at contractual maturity. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

<b>June 30, 2005</b>			
	<b>Amortized Cost</b>		<b>Market Value</b>
Due one year or less	\$ 10,690,003		\$ 10,767,056
Due after one year through five years	38,652,218		38,643,573
Due after five years through ten years	10,582,181		10,941,377
Due after ten years	2,680,027		2,600,771
<b>Total</b>	<b>62,604,429</b>		<b>62,952,777</b>

<b>June 30, 2004</b>			
	<b>Amortized Cost</b>		<b>Market Value</b>
Due one year or less	\$ 8,687,550		\$ 8,778,135
Due after one year through five years	31,463,278		32,213,607
Due after five years through ten years	21,930,972		22,922,307
Due after ten years	9,254,369		8,984,396
<b>Total</b>	<b>\$ 71,336,169</b>		<b>\$ 72,898,445</b>

During the fiscal year ended June 30, 2005, the Old Fund realized \$23K in gross gains from sales of securities and \$25K in gross losses from sales of securities. During the fiscal year ended June 30, 2004, the Old Fund realized \$336K in gross gains from sales of securities.

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During fiscal year 2005, the effect of GASB 31 on Old Fund investment income was a decrease of \$1.2M due to unrealized losses on its long-term portfolio. The effect of GASB 31 on Old Fund investment income for fiscal year 2004 was a decrease of \$3.8M due to unrealized losses on its long-term portfolio.

### **3. Reinsurance**

For the fiscal years ended June 30, 2005 and June 30, 2004, MSF ceded reinsurance to other reinsurance companies to limit the exposure arising from large losses. These arrangements consist of excess of loss contracts that protect against occurrences over stipulated amounts and an aggregate stop loss contract. The excess of loss contracts provide coverage of \$95.0M for both fiscal years 2005 and 2004. During fiscal years 2005 and 2004, MSF retained the first \$5.0M for the first layer of reinsurance coverage. Individual, per person coverage was provided up to \$5.0M per any one individual loss for both fiscal years 2005 and 2004.

The term of the current aggregate stop loss contract is July 1, 2002 through June 30, 2005. The contract provides coverage based on MSF's premium levels at \$8.6M per year but not to exceed \$21.0M in the aggregate over three years. In the event reinsurers are unable to meet their obligations under either the excess of loss contracts or aggregate stop loss contract, MSF would remain liable for all losses, as the reinsurance agreements do not discharge MSF from its primary liability to the policyholders.

Premium revenue is reduced by premiums paid for reinsurance coverage of \$6.8M and \$6.6M in fiscal years 2005 and 2004, respectively. The aggregate stop loss contract requires that MSF maintain a funds withheld account which represents the basic premium portion of the total premium paid for aggregate stop loss coverage. The total funds withheld account at June 30, 2005 is \$7.8M. The funds withheld account at June 30, 2004 was \$4.8M. Interest must be accrued quarterly at an annual rate of 6.5% on the funds withheld account, resulting in accrued interest of \$547K for fiscal year 2005 and \$326K for fiscal year 2004.

During fiscal years 2005 and 2004, estimated claim reserves were reduced \$10.0M for the amount of reinsurance estimated to be ultimately recoverable on incurred losses due to the Excessive Loss Reinsurance contract. In fiscal year 2005 estimated claim reserves were reduced by an additional \$2.9M for the amount of reinsurance estimated to be ultimately recoverable on incurred losses due to the Aggregate Stop Loss contract.

MSF also has assumed reinsurance relationships with Argonaut Insurance Company, Fireman's Fund Insurance Company and Legion Insurance Company related to Other States Coverage (OSC). MSF assumes risk for OSC claims, which are then covered under MSF's ceded reinsurance contract. Assumed premium for fiscal years 2005 and 2004 is \$2.7M and \$2.0M, respectively. The assumed liability for OSC claims is \$2.4M for fiscal year 2005 and \$1.5M for

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fiscal year 2004.

#### **4. Risk Management**

MSF provides liability coverage to employers for injured employees that are insured under the Workers' Compensation and Occupational Disease Acts of Montana. Workers' compensation claims occurring on or after July 1, 1990, are reported in the MSF. At June 30, 2005, approximately 27,527 active policies were insured by MSF. At June 30, 2004, approximately 26,963 active policies were insured by MSF.

MSF is a self-supporting, competitive state fund and functions as the insurer of last resort. Workers' compensation insurance is mandatory in Montana. Employers may obtain coverage through private carriers, through MSF or through self-insurance if they meet certain criteria. Public entities may self-insure or insure through MSF.

MSF serves as claim administrator on claims for injuries that occurred before July 1, 1990, known as the Old Fund. The Old Fund is considered a debt of the State of Montana and not MSF. Neither MSF or the Old Fund had significant reductions in insurance coverage from the prior year, nor any insurance settlements exceeding insurance coverage. Unpaid claims and claims adjustment expenses are estimated based on the ultimate cost of settling the claims including the effects of inflation and other social and economic factors. When MSF purchases annuity contracts, the claim is settled in full and on a final basis, and all liability of MSF is terminated.

Tillinghast-Towers Perrin, an external actuarial firm, prepares an actuarial study used to estimate liabilities and the ultimate cost of settling claims reported but not settled and claims incurred but not reported (IBNR) for MSF as of June 30, 2005 and June 30, 2004. Because actual claim costs depend on such complex factors as inflation and changes in the law, claim liabilities are recomputed periodically using a variety of actuarial and statistical techniques to produce current estimates that reflect recent settlements, claim frequency, and other economic and social factors. A provision for inflation is implicit in the calculation of estimated future claim costs because reliance is placed both on actual historical data that reflects past inflation and on other factors that are considered to be appropriate modifiers of past experience.

Tillinghast-Towers Perrin provides a range of potential costs associated with reported claims, the future development of those claims and IBNR. MSF management has selected the best estimate within that range as the estimated claims payable, consisting of unpaid claims and claim adjustment expenses, for fiscal years 2005 and 2004. The MSF estimated claims payable is presented at face value, net of estimated reinsurance recoverable, at \$511.6M and \$452.1M, as of June 30, 2005 and June 30, 2004, respectively. The estimated claims payable increased \$59.5M from 2004 to 2005, which included reserve strengthening of approximately \$15.2M on



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prior year claims. MSF currently has no knowledge of any significant environmental or asbestos claims that would contribute to this estimate.

State law requires MSF to set premiums at least annually at a level sufficient to ensure adequate funding of the insurance program during the period the rates will be in effect. Anticipated investment income is considered when computing premium rate levels. State law also requires the MSF Board of Directors to establish surplus above risk based capital requirements to secure MSF against risks inherent in the business of insurance.

Acquisition costs represent costs associated with the acquisition of new insurance contracts or renewal of existing contracts and include agent commissions and expenses incurred in the underwriting process. MSF acquisition costs are capitalized and amortized ratably over the subsequent year. Capitalized acquisition costs at June 30, 2005 and June 30, 2004 are \$1.3M and \$1.1M respectively. For the years ended June 30, 2005 and June 30, 2004, acquisition costs that were amortized are \$1.1M and \$1.5M respectively.

The Old Fund covers the liability and payment of workers' compensation claims for incidents occurring before July 1, 1990. Funding for claims payments was provided by Old Fund Liability Taxes (OFLT) which are no longer in effect. The only OFLT activity that remains is miscellaneous collections and adjustments. Old Fund investment earnings must fund future claims payments.

An actuarial study prepared by Tillinghast-Towers Perrin for the Old Fund as of June 30, 2005 and June 30, 2004, is used to estimate liabilities and the ultimate cost of settling claims that have been reported, but not settled and claims that have been incurred, but not reported (IBNR). Tillinghast-Towers Perrin provides a range of potential cost associated with reported claims, the future development of those claims and IBNR. MSF management has selected the best estimate within that range as the estimated claims payable, consisting of unpaid claims and claim adjustment expenses, for fiscal years 2005 and 2004. As of June 30, 2005, the undiscounted estimated claims payable is \$104.9M and is presented at net present value of \$79.1M discounted at a 5.0% rate. As of June 30, 2004, the undiscounted estimated claims payable is \$108.5M and is presented at net present value of \$80.8M discounted at a 5.25% rate.

Changes in Claims Liabilities for the Past Two Years

The following table presents changes in the aggregate liabilities for MSF and the Old Fund for the past two years net of estimated reinsurance recoverable. The information presented has not been discounted.

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	<b>MSF</b>	
	<b>2005</b>	<b>2004</b>
Unpaid claims and claim adjustment expenses at beginning of year	\$452,115,000	\$413,400,000
Incurring claims and claim adjustment expenses:		
Provision for insured events of the current year	149,541,838	136,058,828
Increase(Decrease) in provision for events in prior years	10,070,475	13,568,639
Total incurred claims and claim adjustment expenses	159,612,313	149,627,467
Payments:		
Claims and claim adjustment expenses attributable to insured events of CY	(25,721,288)	(34,574,875)
Claims and claim adjustment expenses attributable to insured events of PY	(74,449,025)	(76,337,592)
Total payment	(100,170,313)	(110,912,467)
Total unpaid claims and claim adjustment expenses at end of the year	511,557,000	452,115,000

	<b>(OLD FUND - undiscounted)</b>	
	<b>2005</b>	<b>2004</b>
Unpaid claims and claim adjustment expenses at beginning of year	108,499,935	113,180,563
Incurring claims and claim adjustment expenses:		
Provision for insured events of the current year	-	-
Increase(Decrease) in provision for events in prior years	6,691,189	8,215,581
Total incurred claims and claim adjustment expenses	6,691,189	8,215,581
Payments:		
Claims and claim adjustment expenses attributable to insured events of CY	-	-
Claims and claim adjustment expenses attributable to insured events of PY	(10,339,528)	(12,896,209)
Total payment	(10,339,528)	(12,896,209)
Total unpaid claims and claim adjustment expenses at end of the year	104,851,596	108,499,935



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Risk Management Trend Information

The following table illustrates how the earned revenues of MSF plus investment income compare to related costs of loss and other expenses assumed by MSF for fiscal years 1996 through 2005. In addition, cumulative amounts related to estimated and actual paid claims are presented. The information allows for comparison of actual and estimated claims and is a basis for developing revenue and claims information. As data for individual policy years mature, the correlation between original estimates and re-estimated amounts is used to evaluate the accuracy of incurred claims currently recognized for less mature policy years.

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	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
<b>1. Premiums and Investment Revenue</b>										
Earned	137,914	105,177	90,544	82,436	91,220	116,056	129,353	165,581	172,961	162,861
Ceded	519	348	303	260	855	2,952	(465)	5,954	6,563	6,788
Net Earned	137,395	104,829	90,241	82,176	90,365	113,104	129,818	159,627	166,398	156,073
<b>2. Unallocated expenses including overhead</b>	17,451	12,622	14,444	19,050	22,101	26,867	29,528	32,830	40,130	44,865
<b>3. Estimated losses and expenses, end of accident year</b>										
Incurred	95,067	76,067	64,983	64,645	65,957	68,267	81,560	110,153	120,705	134,290
Ceded	-	-	-	-	-	-	-	-	-	-
Net Incurred	95,067	76,067	64,983	64,645	65,957	68,267	81,560	110,153	120,705	134,290
<b>4. Net paid (cumulative) as of:</b>										
End of policy year	15,818	12,589	12,943	13,723	13,177	14,140	16,693	22,982	26,123	25,721
One year later	32,890	28,451	28,222	29,976	29,218	32,888	38,185	48,861	50,888	-
Two years later	42,361	35,706	35,753	39,298	37,555	45,218	52,359	63,773	-	-
Three years later	47,283	39,860	41,004	45,748	43,649	55,248	60,029	-	-	-
Four years later	50,267	43,105	44,478	49,984	48,322	61,846	-	-	-	-
Five years later	52,791	46,478	47,584	54,212	52,027	-	-	-	-	-
Six years later	54,962	48,505	50,188	56,974	-	-	-	-	-	-
Seven years later	57,654	50,402	52,240	-	-	-	-	-	-	-
Eight years later	59,193	52,285	-	-	-	-	-	-	-	-
Nine years later	60,825	-	-	-	-	-	-	-	-	-
<b>5. Re-estimated ceded losses and expenses</b>	-	6,645	609	1,940	-	-	-	-	-	-
<b>6. Re-Estimated net incurred losses and expense:</b>										
End of policy year	95,067	76,067	64,983	64,645	65,957	68,267	81,560	110,153	120,705	127,883
One year later	88,923	67,235	64,308	64,348	66,421	71,094	86,799	110,532	112,609	-
Two years later	77,286	59,054	60,467	66,660	66,662	81,053	91,241	112,443	-	-
Three years later	73,864	60,811	61,989	69,345	70,302	88,157	94,615	-	-	-
Four years later	74,022	64,439	64,944	72,435	72,492	92,329	-	-	-	-
Five years later	73,197	59,079	67,312	73,710	73,423	-	-	-	-	-
Six years later	74,329	60,528	67,772	75,537	-	-	-	-	-	-
Seven years later	76,955	60,630	68,601	-	-	-	-	-	-	-
Eight years later	76,849	60,774	-	-	-	-	-	-	-	-
Nine years later	77,029	-	-	-	-	-	-	-	-	-
Ten years later	-	-	-	-	-	-	-	-	-	-
Eleven years later	-	-	-	-	-	-	-	-	-	-
Twelve years later	-	-	-	-	-	-	-	-	-	-
Thirteen years later	-	-	-	-	-	-	-	-	-	-
Fourteen years later	-	-	-	-	-	-	-	-	-	-
<b>7. Increase (decrease) in estimated net incurred losses and expenses from end of policy year</b>	(18,038)	(15,293)	3,618	10,893	7,486	24,061	13,055	2,290	(8,096)	(6,407)

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**5. Administrative Cost Allocation**

State law (Section 39-71-2352, MCA) requires MSF to separately determine and account for administrative expenses and benefit payments for claims for injuries resulting from accidents occurring before July 1, 1990 (Old Fund) from those occurring on or after July 1, 1990 (MSF). The law also limits annual administrative costs of claims associated with the Old Fund to \$1.25M. MSF allocated \$1.25M in administration costs to the Old Fund in each of fiscal years 2005 and 2004. The Old Fund has an \$893K obligation to MSF in unrecovered administrative costs incurred in fiscal years 2004 and prior. MSF intends to recover this amount in future years where the cost of administering the Old Fund is less than the statutorily permitted \$1.25M.

**6. MSF Distributions**

Dividends Paid to Policyholders

During the fiscal years ended June 30, 2005 and June 30, 2004, the MSF Board of Directors authorized and paid dividends to policyholders for \$5.0M for policy year 2003 and \$1.9M for policy year 2002, respectively.

Payments from Old Fund to MSF and State of Montana

House Bill Number 363 (HB 363), enacted by the 2003 Montana Legislature, changed existing law regulating the Old Fund transfer of surplus. HB 363 removed the 10% contingency reserve requirement for the Old Fund and transfers the reserve as well as any remaining available funds from Old Fund to the State of Montana General Fund.

The transfer amount to the General Fund in fiscal year 2005 is \$0 and for 2004 is \$816K. Refer to Note 7 for additional information regarding HB 363.

**7. Old Fund Net Asset Position**

As of December 31, 1998, the Old Fund Liability Tax was terminated and a process was put in place to measure the status of the Old Fund's surplus level annually on a present value basis using a discount factor of 5.0% to determine compliance with state law requirements for maintaining fund adequacy.

Section 39-71-2352 (5), MCA, provided for the payment of excess funds from the Old Fund to the State of Montana General Fund based on adequate funding levels in the Old Fund. This law defined the term "adequately funded" to mean the present value of:

- a) the total cost of future benefits remaining to be paid; and,
- b) the cost of administering the claims; and,
- c) adjusted for any unrealized gains and losses.



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As stated in Note 6, HB 363, enacted by the 2003 Montana Legislature, changed the law regulating the Old Fund transfer of surplus. HB 363 requires the transfer of any amounts above the amount of "adequately funded" to the State of Montana General Fund. In addition, future excess funds will continue to be transferred to the General Fund.

As a result of HB 363, excess funds to be transferred to the General Fund as of June 30, 2004 are \$816K. There were no excess funds to transfer to the General Fund as of June 30, 2005. In order to value liabilities consistently with investments, the estimated claims liability discount rate is 5.0% in 2005 and 5.25% in 2004. The Old Fund net asset level using a present value discount factor of 5.0% is \$(15.6M) as of June 30, 2005. Using a present value discount factor of 5.25% as of June 30, 2004 the net asset level is \$(7.4M). The negative fund balance for June 30, 2005 is the direct result of the transfers made from the Old Fund to the General Fund mandated by HB 363. This does not indicate that the Old Fund does not have adequate financial resources to satisfy current claims obligations. Applying the current actuarially estimated payout pattern of the Old Fund there is sufficient invested assets to meet its obligations until the year 2014. At that time current law would require the General Fund to satisfy all outstanding claims when the Old Fund has liquidated all financial resources and cannot meet its obligations.

#### **8. Compensated Absences**

MSF supports two leave programs, the State of Montana Leave Program and the MSF Personal Leave Program, implemented in January 2002. The State of Montana Leave Program covers all union represented employees. Union represented employees accumulate both annual leave and sick leave and MSF pays employees 100% of unused annual leave and 25% of unused sick leave upon termination. MSF also pays 100% of unused compensatory leave credits upon termination to nonexempt employees. MSF Personal Leave Program covers all non-union employees. Non-union employees accumulate personal leave and extended leave. MSF pays employees for 100% of unused personal leave upon termination but extended leave has no cash value at the time of termination.

MSF absorbs expenditures for termination pay in its annual operational costs. MSF may allocate some of these costs to Old Fund as a portion of the Old Fund administrative cost allocation. The total leave liability for MSF and Old Fund is \$1.8M and \$0, respectively, for fiscal year 2005. The total leave liability for MSF and Old Fund is \$1.7M and \$0K, respectively for fiscal year 2004.

#### **9. Retirement Plans**

MSF and its employees contribute to the Public Employees Retirement System (PERS), which offers two types of retirement plans administered by the Public Employees' Retirement Board (PERB). The first plan is the Defined Benefit Retirement Plan (DBRP), a multiple-employer, cost-sharing plan that provides retirement, disability and death benefits to plan members and their

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beneficiaries. Benefits are based on eligibility, years of service and highest average compensation. Vesting occurs once membership service totals five years. Benefits are established by state law and can only be amended by the legislature.

The second plan is the Defined Contribution Retirement Plan (DCRP), created by the 1999 legislature and available to all active PERS members effective July 1, 2002. This plan is a multiple-employer, cost-sharing plan that also provides retirement, disability and death benefits to plan members and their beneficiaries. Benefits are based on the balance in the member's account, which includes the total contributions made, the length of time the funds have remained in the plan, the investment earnings less administrative costs.

Eligible PERS members choose to participate in either the DBRP or DCRP but may not be active members of both plans. MSF and its employees are required to contribute 6.9% of annual compensation in fiscal years 2005 and 2004. MSF's contributions amounted to \$867K for fiscal year 2005 and \$830K for fiscal year 2004. MSF and its employees paid one hundred percent of required contributions to PERS and there is no unpaid liability as of June 30, 2005.

The PERS financial information is reported in the Public Employees' Retirement Board *Comprehensive Annual Financial Report* for the fiscal year-end. It is available from PERB at 100 North Park Avenue, Suite 220, P. O. Box 200131, Helena, MT 59620-0131, 406 444-3154.

MSF and its employees are eligible to participate in the State of Montana Deferred Compensation Plan (457 plan) administered by the PERB. The Deferred Compensation plan is a voluntary, tax-deferred retirement plan designed as a supplement to other retirement plans. Under the plan, eligible employees elect to defer a portion of their salary until future time periods. MSF incurs no costs for this plan.

## **10. Building**

The 1981 Legislature appropriated funds for the construction of a workers' compensation building. As of July 1, 1990, MSF transferred the value of the building from its records to the Department of Administration, which owns most other state buildings and charges agencies rent for their use. Under an agreement, which expires on July 31, 2007, MSF pays all costs associated with the building, including utilities, property taxes, janitorial services, and maintenance in lieu of paying rent.

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## 11. Contingencies

***Murer, et al v. Montana State Compensation Mutual Insurance Fund, et al.***, WCC No. 9206-6487, involves the 1987 legislature's capping of workers' compensation benefits (\$299.00 a week for total benefits and \$149.50 a week for partial benefits) for injuries occurring during the period July 1, 1987 through June 30, 1989. The 1989 legislature reenacted those caps for the period July 1, 1989 through June 30, 1991 for injuries occurring between July 1, 1989 and June 30, 1991.

The Montana Supreme Court found that these caps should have expired on June 30, 1989 for injuries occurring between July 1, 1987 and June 30, 1989 and should have expired on June 30, 1991 for injuries occurring between July 1, 1989 and June 30, 1991.

The Montana Supreme Court determined a "common fund" had been created.\* As a result, the Montana State Fund, under Workers' Compensation Court direction, performed a review of approximately 7500 claims. Those claims qualifying are paid 85% of the increased rate, with 15% paid to the claimant attorney. The current benefit costs and fees in Murer total approximately \$2.0 million. The cost impact has been paid or is included in Montana State Fund's loss reserves. The review and payment process is almost complete. This case will not be reported in future years due to the nearly completed process.

\* The common fund doctrine was first addressed for workers compensation claims in *Murer v. State Compensation Mutual Ins. Fund*, 283 Mont. 210, 223, 942 P.2d 69, 76 (1997), as follows:

When a party, through active litigation, creates a common fund which directly benefits an ascertainable class of non-participating beneficiaries, those non-participating beneficiaries can be required to bear a portion of the litigation costs, including reasonable attorney fees. Accordingly, the party who creates the common fund is entitled, pursuant to the common fund doctrine, to reimbursement of his or her reasonable attorney fees from that fund.

***Stavenjord v. State Compensation Insurance Fund.*** The first *Stavenjord* decision was issued by the Workers' Compensation Court on May 22, 2001. It addressed the issue of whether the failure of the Occupational Disease Act (ODA) to provide PPD (permanent partial disability) benefits equivalent to the benefits provided in the Montana WCA (workers' compensation act) violates the claimant's right to equal protection of the law. Relying on the *Henry* case (previous case from the Supreme Court finding that vocational rehabilitation benefits must also be paid under the ODA), the court held that MCA §39-72-405 is unconstitutional as applied to Debra Stavenjord. "Where PPD benefits calculated pursuant to the WCA are greater than the benefits available to a claimant under the ODA, constitutional equal protection guarantees require that benefits be computed and paid in accordance with the WCA. The claimant in this case is entitled to \$27,027 under the WCA, versus \$10,000



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under the ODA.” The Montana Supreme Court affirmed the case on April 1, 2003. On August 27, 2004 the Workers Compensation Court held that *Stavenjord* is retroactive to June 3, 1999 (the date of the *Henry* decision). The Court held that a common fund is created for claimants reaching Maximum Medical Improvement on or after June 3, 1999. The cost of retroactively paying benefits for claims in the period of June 3, 1999 through May 21, 2001, is estimated at \$2.2 million and is recorded in the loss reserves of the financial statements. There is no impact on the Old Fund liability with this ruling. This decision has been appealed to the Montana Supreme Court. Should the ultimate decision of the Montana Supreme Court be to create a common fund and apply the decision retroactively to 1987, the cost is estimated at \$14 to \$19 million dollars for the Montana State Fund (New Fund- for claims on or after July 1, 1990). Should the ultimate decision of the Montana Supreme Court be to apply the decision retroactively to 1987, the impact on the Old Fund liability for claims that occurred before July 1, 1990 is estimated at \$5 to \$7 million. Final disposition is unknown at this time. The outcome of a ruling reversing the Workers’ Compensation Court by the Montana Supreme Court that would increase MSF and state of Montana liability is reasonably possible. Actual cost impact should the Montana Supreme Court reverse the Workers’ Compensation Court ruling is unknown.

***Schmill v. Liberty Northwest Insurance***, 2003 MT 80, decided April 10, 2003 by the Montana Supreme Court held as follows, “We conclude that the ODA and the WCA treat similarly situated classes of workers differently. Furthermore, apportioning Schmill’s permanent impairment award for her occupational disease pursuant to § 39-72-706, MCA, of the ODA while providing full benefits for injured workers pursuant to the WCA is not rationally related to a legitimate governmental interest. Therefore, we conclude that § 39-72-706, MCA, violates the equal protection guarantee found at Article II, Section 4 of the Montana Constitution. The judgment of the Workers’ Compensation Court is affirmed.” The Workers’ Compensation Court determined that a common fund existed and the case was retroactive to July 1, 1987. This decision was affirmed on appeal to the Montana Supreme Court. The June 7, 2005 decision of the Montana Supreme Court created a common fund and applied the decision retroactively. The cost is estimated to be \$1.4 to \$1.9 million dollars for MSF. The decision of the Montana Supreme Court is estimated to impact the Old Fund liability in the amount of \$800,000 for claims that occurred before July 1, 1990. This was not a case against the Montana State Fund, but the holding of this decision applies to Montana State Fund and the Old Fund. Implementation of the common fund has begun under the direction of the Workers’ Compensation Court. This case has been recorded in loss reserves.

***Satterlee v. Lumberman’s Mutual Casualty Company et al.***, WCC No. 2003-0840, was filed before the Workers’ Compensation Court on July 18, 2003. The *Satterlee vs. Lumberman’s Mutual Casualty Company* case challenges the constitutionality of state statute, (39-71-710, MCA) passed by the Montana Legislature in 1981. That statute authorizes termination of permanent total disability benefits and rehabilitation benefits when a claimant receives or becomes eligible to receive full Social Security retirement benefits or an alternative to that plan. Should the statute be found to be unconstitutional as applied to permanent total benefits, *Satterlee, et al.* request payment of lifetime permanent total disability benefits. In addition, the

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petition requests certification of this case as a class action or the establishment of a common fund for similarly situated claimants. Petitioners filed a motion and brief for summary judgment on the constitutional issue. The Worker's Compensation Court provided an opportunity for any workers' compensation insurer to intervene until June 6, 2005. Briefing is to be completed by September 15, 2005, and oral argument is set for October 7, 2005. Should 39-71-710, MCA ultimately be held to be unconstitutional as applied to permanent total disability benefits by the Workers' Compensation Court and/or the Montana Supreme Court, and also found to apply retroactively, the cost impact has been estimated for non-settled claims arising on or after July 1, 1990 through December 22, 2004 at \$135 million to \$186 million. The estimated cost of retroactively applying the decision to the Old Fund, for non-settled permanent total disability claims that occurred before July 1, 1990 is \$93 million to \$116 million. The potential for liability for MSF and the State of Montana is reasonably possible. Actual cost impact is unknown.

***Reesor v. Montana State Fund, 2004 MT 370.*** *Reesor* was receiving social security retirement benefits at the time he suffered an industrial accident. He received an impairment award but was denied other permanent partial disability (PPD) benefits pursuant to section 39-71-710, MCA, which provides that persons who are receiving social security benefits or are eligible for full social security retirement benefits are ineligible for PPD benefits other than an impairment award. *Reesor* challenged the constitutionality of section 39-71-710, MCA, on equal protection grounds and sought full PPD benefits. On July 26, 2003, the Workers' Compensation Court found 39-71-710, MCA, to be constitutional. *Reesor* appealed to the Montana Supreme Court, where on December 22, 2004, the Court held that limiting *Reesor's* permanent partial benefit pursuant to 39-71-710, MCA, violated the Equal Protection Clause of the Montana Constitution. MSF has estimated the cost of benefits associated with a retroactive application of *Reesor*. MSF's estimate did not include claims with entitlement dates occurring on or after July 1, 1991 through June 30, 1995 because the *Russette* decision appears to make *Reesor* inapplicable during that timeframe. Excluding the *Russette* timeframe, for claims arising on or after July 1, 1990 through December 22, 2004, the increase in benefit costs for MSF is estimated at \$2.0 million. For claims arising on or after July 1, 1987 through June 30, 1990, the retroactive application of *Reesor* will result in an estimated benefit cost increase of \$1.0 million for the Old Fund. The potential for the litigation to create a liability for MSF and the state of Montana is reasonably possible. Actual cost impact should decision be applied retroactively is unknown.



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October 24, 2005

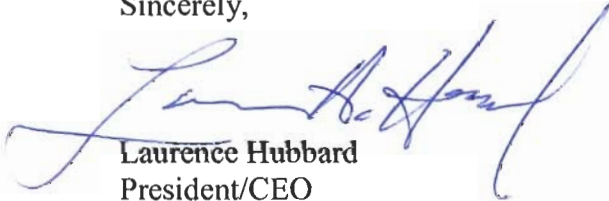
Mr. Scott A. Seacat  
Legislative Audit Division  
Room 160, State Capitol  
Helena, MT 59620-1705

Dear Mr. Seacat:

Montana State Fund (MSF) appreciates the efficient and professional approach of the audit staff involved in this review of our governmental financial statements. Once again, we are pleased with your issuance of an unqualified opinion without any audit recommendations on the financial statements we have presented.

The management and staff of MSF are very proud of our accomplishments in serving Montana businesses. We continually strive to improve our operations to ensure Montana businesses and the community will continue to benefit from a strong Montana State Fund many years into the future.

Sincerely,



Laurence Hubbard  
President/CEO

Montana's insurance carrier of choice and industry leader in service